

## ADDRESSING GOVERNANCE ISSUE IN ISLAMIC REAL ESTATE INVESTMENT (I-REITs): A CASE STUDY FOR OIC COUNTRY -MALAYSIA

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The implementation of good governance practices for Islamic products and services is significantly important in order to ensure its sustainability in the long-run. Furthermore, the strong regulatory framework of governance structures which is based on Shari'ah principles can help to reduce fraud, dishonesty and other unethical practices in doing businesses. Nevertheless, for a new Islamic product such as Islamic real estate investment trust, lack of specific standards and guidelines stated for the appointment of Shari'ah Advisor (SA) may distort the optimum growth and future development of this product. Thus, this paper examine the practice of selecting Shari'ah Advisory Committee by Islamic REIT companies in Malaysia using five standard governance framework which are independence, confidentiality, competence, consistency and disclosure. The data are taken from the Islamic REITs' companies' annual reports and interviews with relevant authorities such as Bank Negara Malaysia and Securities Commission Malaysia. Results from this study suggest that information of Shari'ah Advisory Board/Committee members and qualifications are not properly disclosed in the annual report and the term of appointment of Shari'ah Advisory Committee in some of the REIT companies is too long. In addition, the elements of

Islamic auditing or reporting are vague. These factors are significantly important as they show the important role of good governance in ensuring the faith of investors is not being compromised and the Islamic REIT is Shari'ah compliant. Thus, it can be concluded that more effort need to be put forward in producing a good Islamic governance framework for Islamic REIT.

**Keywords:** Islamic Real Estate Investment Trust, Shari'ah Compliance, Islamic Governance

## INTRODUCTION

There is no doubt that the global financial landscape of Islamic capital market is experiencing positive growth in the recent years. As reported in the 2014 Islamic Finance Outlook by KFH Research Limited, the size of global Islamic finance assets is amounted to US\$2 trillion. The positive growth in size shows the increase in demand for Islamic investment products. These products, which are developed based on Shari'ah principles contribute significantly to the development and great prospect of Islamic Capital Market. This is also a reflection of the successful initiatives and introduction of new asset class type of investment known as Islamic Real Estate Investment Trust (I-REITs).

According to the Security Commission of Malaysia (SC), Islamic REITs is defined as “a collective investment scheme in real estate in which the tenant(s) operates permissible activities according to the Shari'ah principles.” Rosli (2005) stated that Shari'ah principles are defined based from Al-Quran and Sunnah, which differentiate “halal” and “haram”. The Shari'ah principles which are related to Islamic-REITs are the prohibition of riba, avoidance of uncertainty (gharar), prohibition of gambling (maisir) and disengagement from production of impure commodity.

Malaysia was the first country in the world to introduce Islamic REITs in 2006 (Karim, 2012). Islamic-REITs assist in increasing regional and international investment flows by attracting global Islamic investors to diversify their investment portfolio in Shari'ah-compliant securities (Hwa, 2007). Islamic-REITs's investors will receive expected returns from rental income (dividend) and capital appreciation and capital gain resulting from the holding of real estate assets over the investment periods (Hwa, 2007). Through Islamic REITs, investors are able to tap into a larger type of Shari'ah-compliant commercial properties (Hwa, 2007) such as residential, commercial, and retail properties, storage facilities, warehouses and car parks

(Dasuki, 2007).

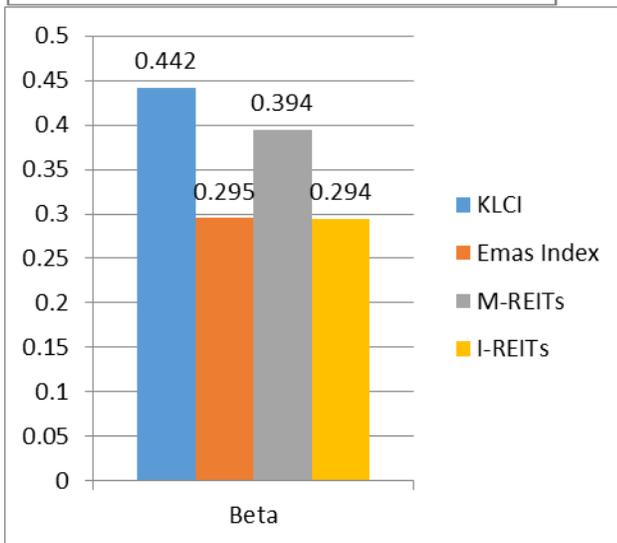
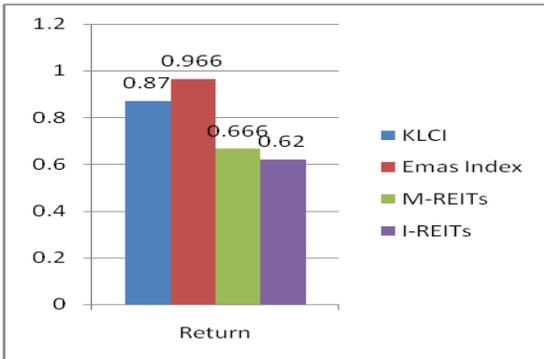
Further clarification of investment scope for Islamic REITs investment is highlighted in the Islamic REITs guidelines issued by the Security Commission of Malaysia ([www.sc.com.my](http://www.sc.com.my)). These include asset backed securities, single-purpose companies, liquid assets, real estate, real estate related assets and non-real estate related assets ([www.sc.com.my](http://www.sc.com.my)).

The Shari'ah Compliance in Islamic REITs is applicable to the rental of real estate, investment, deposit and financing, insurance / takaful and risk management. According to Shanmugan and Zahari (2009), the management of Islamic REITs' companies must also in compliance with the prohibition of dishonesty, ambiguity, fraudulent and exploitation in their business activities. Surah Al-Maidah (Sura No 5, verse 119) has stated:

*“This is a day (Qiyamah) on which the truthful will profit from their truth. For them there are gardens, with rivers flowing beneath, it is their eternal home, Allah is well-pleased with them, and they will be pleased with Him and that will be the great salvation for human beings”.*

In this regards, the verse of this surah states that people, which include businessmen, who are honest and being truthful will be rewarded. Evidently, the performance of Islamic REITs is better compared to the performance of the Conventional REITs based on risks and returns (see Figures 1a and 1b). From Figure 1a, the return for Malaysia REITs (M-REITs) is 0.004% more than the return for Islamic REITs (I-REITs). However, the risk for Islamic REITs (see Figure 1b) is lower than the Malaysian REITs. This proves that Islamic REITs has significant potential to expand into new frontier where it can be used to manage financial risk. In addition, the governance of Islamic REITs is being carried out by professional Shari'ah advisors who are knowledgeable in Islamic business activities (see Figure 1)

**Figure 1. Comparison of Return between KLCI, 1b) Comparison of Risk between KLCI EmasIndex , M-REITs and I-REITS Emas Index, M-REITs and I-REITs**



**Time period: M-REITs; August 2005 to Dec 2010; I-REITs, August 2006 to Dec 2010**

Although there are growing prospects of I-REITs as investment tools, there is very limited academic research on the governance of Islamic REITs. According to Momna (2011), there are many issues causing the slowing down in the development of I-REITs which include the lack of standardized governance framework for Islamic REITs and limitation of global investment. Albaker (2007) also discussed several issues and challenges for Islamic REITs such as the mixed activities carried out (non-halal and halal activities), standardization of Islamic REITs, lack of developed secondary market and lack of appropriate index for pricing.

In recognition of the increasing size and growing interest of investors for Shari'ah compliance investment, this paper attempts to analyze the level of governance practice carried out by REIT companies in Malaysia in selecting the Shari'ah Advisory Committee. Apparently this informal

Islamic Governance has not been highlighted significantly in addressing risk management issues in Islamic REITs.

This paper contributes to the extant literature in several aspects. First, prior research explored the performance and general introduction about Islamic REITs, but did not address the importance of Islamic governance to REITs industry. Second, to the best of our knowledge, no research has been conducted in the area of Islamic governance for Islamic REITs. Contemporary research on Islamic REITs is only interested to compare the performance of Islamic REITs and conventional REITs (see Ong, et.al, 2012; Hamzah and Rozali, 2010; Ibrahim and Ong, 2008 and Osmadi, 2006) and provide brief description of Islamic REITs in general (see Momna, 2011; Osmadi, 2006; Hwa, 2007 and Albaker, 2007). The issue of Islamic governance in Islamic REITs has yet to be explored by researchers especially in Malaysia. Third, the improvement in Islamic governance structure for Islamic REITs can help to increase public confidence, thereby increasing trust among unit trust holders (investors) and other parties dealing with Islamic REITs.

The structure of this paper is constructed as follows. The next section in the literature review elaborates on the overview of Islamic governance according to Shari'ah principles. Section three presents the three Islamic REITs in Malaysia. Section four discusses the data and methodology which include the five governance elements used in the Islamic governance framework. Section five reports the results, and the final section provides the concluding remarks and implications.

### **Islamic Governance: an Overview**

The principles of Islamic governance are not new to Islamic economy as they have been embedded in an appropriate ethical environment governed by Shari'ah (Abu-Tapanjeh, 2009). Although the issue of corporate governance has been the interest of many international organizations such as Islamic Development Bank (Chapra, 1992, Ahmad, 2000), there is a lack of research on corporate governance from Islamic's perspective and none Arabic expression has been used formally to define corporate governance (Sourial, 2004).

In Islam, the corporate governance model is described comprehensively through the elements of ethics as propounded in Al-Quran and Al-Sunnah as the primary sources. Other secondary sources are Ijmak (consensus of opinion), Qiyas (analogical deduction) and Maslahah (public interest). The ethics is describe by a view of Al-Ghazali (1937; 134-144); "Ethics is part and parcel of Maqasid-al-Shari'ah (guiding principles of Shari'ah); whereby it protects the welfare

of the people, which safeguards their faith, life, intellectual, posterity and wealth. Hence, corporate governance in Islam is more concerned on the internal moral enthusiasm of fulfilling the task in accordance to Islamic Shari'ah.

Shari'ah governance refers to a set of organizational arrangements for Islamic financial institutions (IFI) to ensure the effectiveness of independent supervisions of the issues and dissemination of Shari'ah guidelines (Grais and Pellegrini, 2006a). According to Muslim scholars, Shari'ah is a conceptually set of rules, and values covering all aspects of Muslims' life and activities. Incorporating the Shari'ah values of transparent, fair and ethical towards the governance structure of Islamic-REITs demonstrate the close aligned of businesses, economy and society as a whole. According to Lewis (2005), Al-Quran stated that Islam always encourages trade and commerce as long as it is conducted within the framework of Quran and the word of Allah as revealed by his prophet Muhamad (PBUH). Hence, the Islamic governance is not only one of the principles to ensure the successful of a company, products and services but also to ensure security confidence by monitoring and controlling the operation of a company.

The compliance with the Shari'ah and the implementation of Shari'ah governance for Islamic products and services are highly encouraged by many renowned international institutions such as Accounting and Auditing Organization for Islamic Financial Insitutions (AAOIFI) and Islamic Financial Service Board (IFSB) and Bank Negara Malaysia (BNM). The Shari'ah governance guidelines issued by these organization are highlighted in Table 1

**Table 1. Summary of Shari'ah Governance Guidelines by AAOFI, IFSB and BNM**

Organization	Shari'ah Guidelines
Accounting and Auditing Organization for Islamic Financial Insitutions (AAOIFI)	(1) <i>Shari'ah</i> Supervisory Board: Appointment, Composition and Report, (2) <i>Shari'ah</i> Review, (3) Internal <i>Shari'ah</i> Review (4) Audit & Governance Committee for Islamic Financial Institutions (5) Independence of <i>Shari'ah</i> Supervisory Boards, (6) Statement on Governance Principles for Islamic Financial Institutions (7) Corporate Social Responsibility Conduct

	and Disclosure for Islamic Financial Institutions
Islamic Financial Service Board (IFSB)	<ol style="list-style-type: none"> <li>(1) Shari'ah governance system,</li> <li>(2) Competency,</li> <li>(3) Independency,</li> <li>(4) Confidentiality</li> <li>(5) Consistency.</li> </ol>
Bank Negara Malaysia (BNM)	<ol style="list-style-type: none"> <li>(1) Accountability and responsibility,</li> <li>(2) Independence,</li> <li>(3) Competency,</li> <li>(4) Confidentiality</li> <li>(5) Shari'ah compliance</li> <li>(6) Research function.</li> </ol>

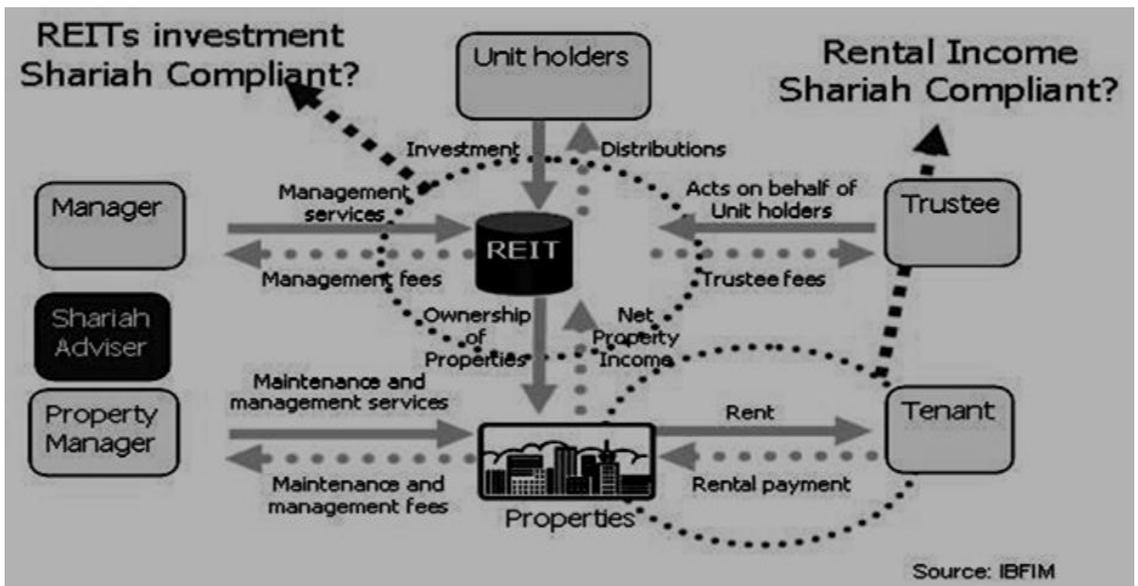
**Source: (Kasim et.al, 2013).**

In Malaysia, Bank Negara Malaysia has established Shari'ah Advisory Council under the virtue of Section 16B of the Central Bank of Malaysia Act 1958(CBA) in order to ensure the practices are in conformity with Shari'ah. Subsequently, the establishment of Advisory Council is according to the "Principle 3.1" of the International Financial Service Board (IFSB) Guiding Principles on Corporate Governance which stated that an appropriate mechanism must be created to ensure the compliance with the Shari'ah principles and boosts the confidence of the shareholders and the public ([www.bnm.org.my](http://www.bnm.org.my))

In almost all jurisdictions, there is the recognition that building a good governance within financial institutions and economy require a set of guidelines and rules. Malaysia has also made the first Jurisdiction in the Global Islamic sector through the issuing of Guidelines for Islamic Real Estate Trusts in 2005 ([www.sc.com.my](http://www.sc.com.my)). This guideline supported the fact that Islam permits the accumulation of wealth according to the main Islamic principles of halal (Shanmugam and Zahari, 2009). To further strengthen the rules on REITs, an Islamic REITs must also comply with the general SC Guidelines on REITs (January, 2005).

Figure 2 highlights the structure of Islamic REITs which is almost similar to the conventional REITs except for the existence of Shari’ah Advisor or Committee. According to this structure, monitoring of Shari’ah compliant is carried out by the Shari’ah Advisory Board/ Committee. The establishment of the Shari’ah Advisory/Committee is a statutory requirement under Islamic Banking Act, 1983 (IBA) and Takaful Act, 1984 (TA) as deliberated in the Guidelines on the Shari’ah Governance Framework for Islamic Financial Institutions issued in 2004.

**Figure 2. Structure of Islamic Real Estate Investment Trust (I-REITs)**



The function of Shari’ah Advisor is to assess regularly on Shari’ah compliance aspect in the activities and operations of the Islamic REITs (Hwa, 2007). In addition, the Shari’ah Advisor is also responsible in ensuring that the management of Shari’ah fund does not contravene with Shari’ah principles (Hwa, 2007).

Apparently, the internal governance structure of Islamic REITs is also similar with other

institutions offering Islamic Financial Services (IIFS) due to the existence of Shari'ah Advisor. According to Grais and Pellegrini (2006) the job specification for Shari'ah Supervisory Board (SSB) covers 5 main areas which include: 1) certification of permissible financial instruments through fatwa; 2) verification of transactions compliance with issued fatwas; 3) calculation and payment of zakat; 4) disposal of non-Shari'ah compliant earnings and 5) advice on the distribution of income and expenses among shareholders.

In Malaysia, the Bank Negara Malaysia has established an Islamic governance for IFIs with effective date January 1, 2011. According to this ruling, the number of Shari'ah Committee members appointed must not be less than five (5), with majority of whom must have strong knowledge in Shari'ah and other qualification such as economics and finance ([www.bnm.org.my](http://www.bnm.org.my)). In addition, the Board of Directors must ensure that the Shari'ah Committee/Advisor members fully understand their fiduciary responsibilities and duties.

In the conventional REITs, the governance related issue is under the supervision of the Trustee (Financial Institutions) and the REITs manager. As for the Islamic REITs, the Trustee, the REITs manager and the Shari'ah Advisor are responsible in governing the business activities of Islamic REITs. Thus, it is proven that the standards of governance in Islamic REITs is further strengthening by the additional layer of governance duty carried out by the Shari'ah Advisor, which need to issue a report to certify that all business transactions compliant with the Shari'ah guidelines.

### **Islamic REITs in Malaysia**

Currently, the market capitalization of Islamic REITs in Malaysia is amounted up to RM 14.85 billion as of 30<sup>th</sup> October 2014 (Bloomberg, KFH Research Limited, 2015). Malaysia, which has been the forefront of the Islamic capital market with the launch the world's first Islamic REITs (Al-Aqar KPJ), and the world's first Islamic plantation (Al-Hadharah Boustead REITs). However, the Hadharah Boustead REITs have been delisted from Islamic REITs in February 2014. Currently, there are three Islamic REITs in Malaysia, which are Al-Aqar Healthcare REITs (formerly known as Al-Aqar KPJ), Axis REITs and KLCC REITs. These Islamic REITs are among the top highest providers of dividend to investors. Table 2 summarizes the information on Al-Aqar Healthcare, Axis REITs and KLCC REITs.

#### **Table 2. Summary of Malaysian Islamic Real Estate Investment Trust**

Islamic REITs	Al-Aqar Healthcare	KLCC REITs	Axis REITs
Market Capitalization	RM932.9 million	RM12.655 billion	RM1689.0 million
Incorporated	May 2006	May 2013	2009
Distribution Yield (August 2014)	5.8%	4.8%	5.08%
Premium/Discount to Net Asset Value	18%	3%	72%
Capital Gains	41%	90%	196%

**Source: Al-Aqar, KLL REITs and Axis REITs annual report and website (Various years)**

Based from Table 2, there are variations among the capital gains and distribution yield for the three Islamic REITs in Malaysia. KLCC REITs has the biggest market capitalization which is RM12.655 billion and this REIT has capital gains of 90% since it's incorporated in 2013. As for Axis REITs, which holds portfolio in offices, industrial spaces, the capital gains is recorded to be 196% for the past 5 years. The demand of offices in Malaysia has contributed to the increase in the return for Axis REITs. Al-Aqar KPJ Healthcare, which is the first Islamic REITs in the world, shows more stable long-term return in term of distribution yield. Overall, the average return for Islamic REITs is the range of 5% to 6% in 2015. These Islamic REITs have proved to be financially sound as they are fully asset backed.

### **Data and Methodology**

The data of this paper are taken from the date of Islamic REITs incorporated until 2015. Various sources such as library research, annual reports of Islamic REITs Companies (Al-Aqar Healthcare, KLCC REITs and Axis REITs) and interview with Shari'ah authority from Securities Commission of Malaysia are being explored. The used of annual report is important as evident of communication between companies and their stakeholders. All important issues such as decision on financial and operation of the businesses are being informed through the annual report (Gray, et.al, 1995 and Guthrie & Abeysekara, 2006).

These annual reports were studied to obtain relevant Shari'ah compliance information such as the Shari'ah Advisor's background and any Islamic reporting in financial statement. Furthermore, the level of implementation with regards to Shari'ah is being examined using five

elements of standard governance framework focusing on Shari'ah Advisor's job task specification of monitoring and governing the Islamic REITs operation (see Figure 3)

**Figure 3. Governance Framework**

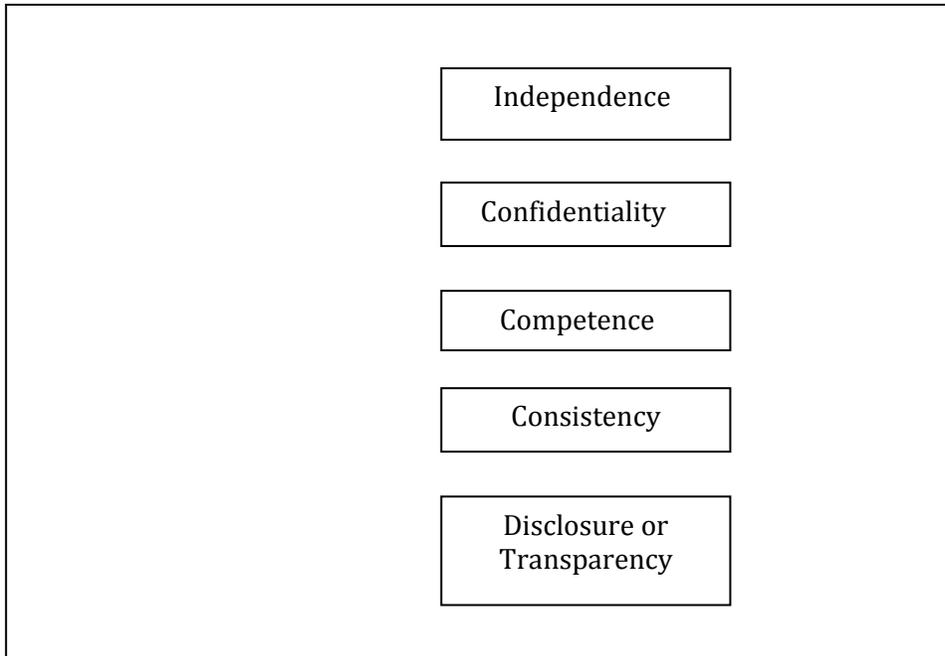


Figure 3 highlights the five commonly used governance principles in several governance policies such as Cadbury Report, Nolan and Australian National Audit Office (ANAO). This conceptual framework provides the guidelines for assessing the practice in selecting Shari'ah advisory committee by the Islamic real estate investment trust (REIT) companies in Malaysia. In addition to the selection process for Shari'ah advisory, the existing Shari'ah advisory's practices is also being examined using these five governance principles by looking into the background of each Shari'ah advisory, the reports issued by Shari'ah advisor and the level of knowledge in each Islamic REITs market (hospital, healthcare, industrial/ offices).

## **Result and Discussion**

Table 3 summarizes the results of this study for Islamic REITs companies in Malaysia. There are mixed findings of this study with regards to the compliances of Islamic governance of Shari'ah Advisors. The results of this study are divided into 5 main criteria of Islamic

governance which are adopted from conventional governance framework.

**Table 3. Islamic Governance Checklist for three Islamic REITs in Malaysia**

Table 3 summarizes the results of this study for Islamic REITs companies in Malaysia. There are mixed findings of this study with regards to the compliances of Islamic governance of Shari'ah Advisors. The results of this study are divided into 5 main criteria of Islamic governance which are adopted from conventional governance framework.

<b>Islamic Governance</b>	<b>Al-Aqar Healthcare</b>	<b>KLCC REITs</b>	<b>Axis</b>
Independence	Yes	Yes	Yes
Confidentiality	Yes	Moderate (IBFIM)	Moderate (IBFIM)
Competence	Yes	Yes	Yes
Consistency	Yes	Yes	Yes
Disclosure of SSB jobs and responsibilities and transparency	Lack of information about SSB.	Lack of information about SSB	Lack of information about SSB

### **Independence**

The independence of these SSB members or SA (Shari'ah Advisors) are implied in the freedom of expressing their assessment and opinion as they are not working in that Islamic Institutions or subject to the authority of the board of directors (Grais and Pelligrini, 2006). This in turn will help to increase their integrity in assessing and monitoring the management of Islamic REITs operation. The result of this study indicates that Axis REITs outsource external Shari'ah Advisors from reputable Islamic Institutions in Malaysia such as Bank Islam and Islamic Banking and Finance Institute Malaysia (IBFIM). Grais and Pelligrini (2006) stated that in any IFIs, members of SSB are appointed by the shareholders of the company, which is the board of

directors. Furthermore, the member of SSB or Shari'ah Advisor must be chosen from among Jurists and men of Islamic and Shari'ah background with a strong belief and faith in Islamic products and services (Bank Negara Malaysia Shari'ah Governance Framework). Evidently, this proved that the appointment of Shari'ah Advisor is accordance to the common standard of governance framework.

### **Confidentiality**

Another aspect of Islamic governance is the confidentiality of information. Islam give preferences to confidentiality of information According to Iman Mawardi, confidentiality is a strength of a man, when he can keep from disclosing other's personal stuff and successfully achieve his goal (Mawardi, 1981). A good relationship can be sustain when one's keep confidentiality of one another. In Islamic REITs sector, the scarcity of Fiqh Al-Muamalat jurists in Malaysia caused Axis REITs to share similar Shari'ah Advisors from IBFIM. From positive point of view, the Shari'ah Advisor team has an excellent background of Fiqh Al-Muamalat that would ensure strict compliance of Shari'ah guidelines of the Islamic REITs operation. However, the drawback of this issue is that it indicates Malaysia is lacking expertise in Islamic background to cater future demand in Shari'ah compliance issues. This gap needs to be addressed seriously as it can slow down the potential growth of Islamic REITs investment.

### **Competence**

The competency aspect for Islamic REITs lies in ability of the Shari'ah's Advisor to know about the firm's fundamental business. Based from the review and analysis of the appointed Shari'ah advisor's educational background, most of them are highly competence to determine the compliance of Islamic REITs's business activities to Shari'ah. All of the Islamic REITs companies Shari'ah Advisors have fulfilled the criteria of academic qualification, experience and exposure to Shari'ah related issues. Furthermore, the Central Bank of Negara Malaysia (BNM), has added more criterion to the Shari'ah's Board Member. This include appointing Shari'ah Advisor from various institutions such as from Islamic Religious Council (Mufti) and Law.

### **Consistency**

Another important aspect of Islamic Governance is the consistency of Shari'ah Advisor's jurisdiction towards any business activities of Islamic REITs companies. The consistency of the Shari'ah Advisor among the three Islamic REITs companies are at the same level. At this point, there is no dispute or grey area which has not been resolved by the SSB. All of the decisions

with regards to Shari'ah issues are consistent among Al-Aqar KPJ, KLCC REITs and Axis REITs.

### **Disclosure or Transparency**

The final aspect of governance is the disclosure of information with regards to the Shari'ah Advisor's educational background, job scope/ responsibilities, decision-making process and publish all the fatwas discussed and agreed upon some 'grey' issues. The findings of this research indicate all REITs companies share limited information about the Shari'ah Advisors job's scope and responsibilities through the auditor's report. In other words, the information has not been published in the company's annual report.

In the Shari'ah Governance Framework issued by the Bank Negara Malaysia, the management of Islamic Institutions or any institutions which offer Islamic products and services should be more transparent in terms of taking unnecessary risks due to the strict imposition of Shari'ah guidelines. The success of Axis REITs in winning the best practice awards in 2012 (Asia Pacific Real Estate Associations- APREA) in four categories; 1) merit-property valuation; 2) accounting and financial reporting; 3) portfolio performance reporting and; 4) corporate governance demonstrated the appreciation of public towards transparency and disclosure issues in business.

Overall, table 3 shows the analysis of the three Islamic REITs companies in Malaysia using five Islamic governance principles. Both KLCC REITs and Axis have less confidential issue due to the appointment of similar Shari'ah Advisory which is from IBFIM. Other governance principles such as independence, competence and consistency convey the same level for all of the Islamic REITs. Nevertheless, the disclosure of Shari'ah Advisory jobs and responsibilities seems to be lacking in all of the Islamic REITs. This governance principles is very important as it can prepared and nurture the Islamic REITs sector in Malaysia to the next level based from the input from the Shari'ah advisory.

### **Discussion and Conclusion**

This paper seeks to contribute to the existing literature of Islamic Governance by reviewing the three Islamic REITs Companies' annual reports, focusing more on the Shari'ah Advisor/ Committee selection and education/experience. As the data gathered for this study is very limited, it is not the intention of this paper to discuss in detail about the Shari'ah Advisor's

responsibilities but rather to identify the level of Islamic governance practice being carried out in Islamic REITs sector.

A particular attention is needed to establish a robust and sustainable framework for Islamic governance in Islamic REITs. There is a lack of standardized reporting format for Shari'ah Advisor report and no information of Shari'ah Advisor's expertise published in the company's annual reports. In addition, the Shari'ah Advisor also needs to have better understanding and knowledge of modern financial and banking practices other than Shari'ah knowledge.

Malaysia has been aggressively promoting Islamic capital market by providing various infrastructures such as Bursa Suq Al-Sila, International Shari'ah Research Academy for Islamic Finance (ISRA), Malaysia International Islamic Finance Centre (MIFC) and International Centre for Education in Islamic Finance (INCEIF). This in turn will help to produce and groom more Shari'ah scholars with greater understanding of Islamic investments.

Hence, it is hoped that more future research can be conducted in this untapped area of Islamic Governance by focusing on the reporting of the financial information in Islamic REITs companies. In conclusion, Islamic governance is very significant to companies as it provides sufficient trust and comfort to investors by ensuring it is in compliance with Shari'ah.

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